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## SEC Issues Concept Release on “Proxy Plumbing”

At its open meeting on July 14, 2010, the SEC voted unanimously to publish a concept release seeking public comment on a variety of issues relating to the mechanics of communications and voting under the SEC’s proxy rules (so-called “proxy plumbing”). The release may be found at <http://www.sec.gov/rules/concept/2010/34-62495.pdf>. Comments must be filed with the SEC on or before 90 days after publication of the release in the Federal Register.

“Proxy plumbing” has attracted significant attention among companies, investors and other market participants in recent years, particularly as contested shareholder votes have grown more common. In her opening remarks, Chairman Schapiro noted that changes in “shareholder demographics, the structure of share holdings, technology, and the potential economic significance of each proxy vote” have driven a need to consider whether changes to the proxy voting system are merited. Reflecting the complexity of the subject, the concept release begins with an extended discussion of the mechanics of share ownership and proxy voting.

The concept release is the first step in what is likely to be a long process before the SEC takes action in this area, particularly given the absence of meaningful data in the case of some of the questions and possible solutions raised. At the open meeting, both Commissioners Aguilar and Walter highlighted the importance of fact-finding as the SEC considers whether to recommend changes. Commissioner Aguilar emphasized in particular the importance of obtaining feedback from individual investors, stating that the concept release reflects mainly concerns and proposed changes raised with the SEC staff by companies and industry groups. Action on proxy infrastructure issues is also likely to be delayed in light of the significant regulatory workload that will result from the expected enactment of financial reform legislation.

The concept release is organized around three general topics: (1) the accuracy, transparency and efficiency of the proxy voting system; (2) communications with shareholders and shareholder participation in voting; and (3) the relationship between voting power and economic interest. The specific topics addressed in the release are summarized below.

## Accuracy, Transparency and Efficiency of the Proxy Voting System

- *Over-Voting and Under-Voting.* Over-voting or under-voting happens when the broker-dealer that holds shares through The Depository Trust Company casts more or fewer votes than the total shares allocated to its customer accounts. This can occur for a variety of reasons, but arises mainly in connection with stock loan transactions and “fails to deliver” in the clearance and settlement system. To avoid over-voting, some broker-dealers have adopted methods of allocating votes among their customers that can result in beneficial owners casting more or fewer votes than they are entitled to cast. Neither the SEC nor broker-dealer self-regulatory organizations now regulate the use of these methods. The release seeks comment on whether over-voting impairs the accuracy and fairness of shareholder votes in a meaningful way. The release also asks whether broker-dealers should be required to disclose the allocation method used and the likely effect of that method on whether customer voting instructions would actually be reflected in the broker-dealer’s proxy sent to the vote tabulator, and whether the SEC should require the use of a particular allocation method. Finally, noting “the lack of empirical data on whether over-voting or under-voting is occurring and if so, to what extent,” the release seeks feedback on whether this information should be collected from proxy participants in order to evaluate appropriate regulatory responses.
- *Vote Confirmation.* Under today’s system, shareholders and companies have limited ability to confirm whether votes were in fact cast in accordance with the relevant instructions. The release acknowledges that “the inability to confirm that votes have been timely received and accurately recorded creates uncertainty regarding the accuracy and integrity of votes cast at shareholder meetings. At a time when votes on matters presented to shareholders are increasingly meaningful and consequential to all shareholders, this lack of transparency could potentially impair confidence in the proxy system.” The release seeks comment on ways vote confirmation could be enhanced, notably whether participants in the voting chain should grant companies access to their records for this limited purpose.
- *Securities Lending.* Institutional shareholders often lend shares, and loaned shares typically cannot be voted by the lending shareholder unless recalled. It is often difficult for lenders to learn what matters will be voted on at a meeting until the relevant proxy statement is distributed, which is generally not until after the record date for the meeting has occurred. The release seeks comment on whether companies should be required to provide notice about the meeting agenda prior to the record date, so that lenders under stock loans can make more timely recall decisions. The SEC also asks whether mutual funds should disclose the number of votes cast at a meeting, in addition to existing requirements to disclose how they voted on each matter submitted to shareholder vote.
- *Proxy Distribution Fees.* Brokers and other intermediaries are now entitled to receive “reasonable reimbursement” for forwarding communications from companies to

shareholders, according to fee structures established by broker-dealer self-regulatory organizations. As a practical matter, since most firms that provide this service are members of the NYSE or of exchanges with rules similar to those of the NYSE, the NYSE fee schedule applies in almost all cases. The release seeks comment on whether the existing fee schedule should be revised or whether the system of fixed reimbursement should be eliminated entirely so as to permit fees to be established by market forces.

### **Communications with Shareholders and Shareholder Participation in Voting**

- *Communication with Beneficial Owners.* The SEC staff noted that some companies have expressed concern about their ability to communicate directly with beneficial owners under the current system, as well as the costs of the current communications system. Under SEC rules, companies communicate with beneficial owners principally through broker or bank intermediaries. A company cannot contact directly beneficial owners of securities held in “street name” with broker or bank intermediaries if they object to disclosure of their identities to the company (so-called “objecting beneficial owners” or “OBOs”). While the company may contact non-objecting beneficial owners (so-called “NOBOs”), SEC rules require that proxy materials be forwarded to them by the intermediaries. As a result, a company’s ability to communicate directly with its beneficial owners is hampered. Chairman Schapiro noted that the concept release asks whether this framework “still represent[s] the most appropriate regulatory response to the competing interests of privacy versus effective shareholder-corporation communications.” The release seeks comment on a variety of approaches to facilitate direct communication from companies to shareholders, including the elimination or modification of the OBO/NOBO framework or requiring securities intermediaries to transfer proxy voting authority to beneficial owners.
- *Retail Investor Participation.* At the open meeting, several Commissioners focused on the importance of promoting voting by “retail” investors, who represent a non-trivial portion of the voting power of public companies, but typically have low voting rates, particularly in the wake of the SEC’s “notice & access” rules permitting Internet delivery of proxy materials. Expressing similar concerns, the release seeks comment on strategies to increase voting by individual shareholders. Strategies for consideration include investor education; enhancing brokers’ online platforms to enable voting; permitting retail shareholders to give advance voting instructions (sometimes referred to as “client directed voting”); facilitating investor-to-investor communications; and improving the use of the Internet to distribute proxy materials to investors.
- *Data-Tagging.* The release seeks comment on whether data-tagging of information contained in annual proxy statements, particularly information about executive compensation and director qualifications, and mutual fund voting disclosures would enhance the ability of shareholders to analyze the disclosures and make informed voting

decisions. The staff noted they are particularly interested in evaluating the potential costs associated with data-tagging.

### **Relationship Between Voting Power and Economics**

- *Role of Proxy Advisory Firms.* The release discusses concerns raised by companies and other observers about the role of proxy advisory firms in the voting process, notably that these firms may have undisclosed conflicts of interest in establishing voting guidelines and may fail to conduct adequate research or rely on erroneous data in making voting recommendations with respect to specific management or shareholder proposals. Similar concerns were echoed by Commissioner Casey during the open meeting. The release also notes that “some have argued that proxy advisory firms are controlling or significantly influencing shareholder voting without appropriate oversight, and without having an actual economic stake in the issuer.” The release seeks comment on ways to address these issues, as well as views as to how these issues may be affected by the powerful marketplace position of Institutional Shareholder Services, which the release characterizes as being the “dominant” firm “whose long-standing position, according to the Government Accountability Office, ‘has been cited by industry analysts as a barrier to competition.’” Strategies for consideration include heightened oversight of proxy advisory firms and disclosure about conflicts of interest and how these firms develop voting recommendations.
- *Dual Record Dates.* Companies typically set a single record date for determining shareholders entitled to receive notice of and to vote at a meeting. Because the SEC’s proxy rules generally require proxy materials to be distributed to shareholders several weeks in advance of a meeting, shareholders as of the record date often have sold their shares by the time of the meeting, creating a mismatch between voting rights and economic interest. To address this issue, Delaware law (which governs many public companies) was amended in 2009 to permit separate record dates for notice and voting. The release requests comment on whether the SEC’s proxy rules should be revised to accommodate the use of dual record dates.
- *Empty Voting.* “Empty voting” occurs when a person has the right to vote shares that substantially exceeds the person’s economic interest in the company. As the release discusses, empty voting challenges “the foundational understanding that, absent contractual or legal provisions to the contrary, a ‘shareholder’ possesses both voting rights and an economic interest in the company.” As noted at the open meeting, this decoupling can be achieved in various ways, such as through the use of hedging strategies, selling shares between the voting record date and the actual voting date, voting of unallocated shares in an employee stock option plan, or borrowing shares immediately before the voting record date and returning them immediately thereafter. The release seeks comment on the scope and significance of empty voting, the costs and benefits of practices that decouple voting and economic interests, and ways to address

resulting concerns, such as requiring disclosure of practices that could result in empty voting.

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If you have any questions about the concept release or would like assistance in preparing a comment, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed on our website under “Capital Markets” or “Corporate Governance.”

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